No. 16663

United States
Court of Appeals
for the Ninth Circuit.

O. H. KRUSE GRAIN & MILLING,

Appellant,

-vs-

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

APPELLANT'S OPENING BRIEF

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TABLE OF AUTHORITIES

[CASES CITED]

STATUTES

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JURISDICTION

Appellant O. H. Kruse Grain & Milling is a corporation duly organized and existing under and by virtue of the laws of the State of California, with its principal office at 1459 North Tyler Street, El Monte, California. This proceeding involves federal income taxes, and the tax returns for the years involved were filed with the

District Director of Internal Revenue for the Sixth District of California. The principal place of business of appellant corporation, O. H. Kruse Grain & Milling, is within the jurisdiction of the Tax Court of the United States and the United States District Court for the Southern District of California, and within the jurisdiction of the Ninth Circuit of the United States Court of Appeals.

The trial took place in the Tax Court of the United States before Honorable James E. Mulroney, Judge presiding, on January 8, 1959, in the Tax Court located in the Federal Building, Los Angeles, California.

PRELIMINARY STATEMENT

The controversy involves federal income taxes proposed to be assessed against the appellant corporation for the taxable years 1952 and 1953, in the amounts of $5,555.28 and $9,048.53, respectively, resulting from the appellee's (Commissioner's) determination that a certain promissory note issued by appellant, in payment for certain assets owned by O. H. Kruse having a value equal to the principal amount of said note, did not evidence a bona fide indebtedness of the appellant within the meaning of Section 23(b) of the Internal Revenue Code of 1939.

Section 23(b) is set out in the appendix on page A.

APPELLANT'S STATEMENT OF FACTS

Appellant is a corporation organized under the laws of the State of California on March 27, 1950, with its principal place of business located in El Monte, California. (Stipulation, See, Tr. p. 24). O. H. Kruse, sometimes referred to in the record as Otto H. Kruse, president of appellant corporation, had been engaged in the hay, grain and feed business for a period of fourteen (14) years prior to 1950. (Stipulation, See Tr. p. 24). In April , 1950, O. H. Kruse and his wife, Helen D. Kruse, formed appellant corporation using the name O. H. Kruse Grain & Milling as the name of the corporation, which was the same name as O. H. Kruse had used in conducting his business as a sole proprietorship. (Stipulation, See Tr. p. 24).

The appellant corporation had an authorized capital stock of $300,000.00, consisting of 3,000 shares of $100.00 par value each. (Stipulation, See Tr. p. 24).

On April 1, 1950, O. H. Kruse transferred to appellant, in exchange for 800 shares of stock, the following property:

(Stipulation, See Tr. pp. 24-25).

Office equipment	$ 1,865.76	
Autos and trucks	57,135.27	
Machinery and equipment	64,113.91	
	$123,114.94	
Less accrued depreciation	44,050.41	$79,064.53
Prepaid insurance		4,163.67
Insurance deposits less accrued premiums		2,293.48
Cash		4,270.55
		$89,792.23

In this transaction petitioner assumed liabilities of O. H. Kruse, as follows: (Stipulation, See Tr. p. 25).

Notes payable (bank)	$8,000.00
Accounts payable (trade)	1,710.00
Accrued payroll taxes (due 12/31/50)	82.23
	$9,792.23

The minutes of the meeting of June 15, 1950 of the Board of Directors of the petitioner corporation (appellant's Exh. 5) show the following:

> Mr. Kruse then stated that he had advanced funds to the corporation for working capital, and that he would be willing to accept the corporation's promissory note for $200,000.00 payable December 31, 1950, to bear interest at the rate of 6% per annum beginning January 1, 1951, if the note should be unpaid on that date. The balance of the advance could be carried as an open account. Payments to Mr. Kruse, other than those on the promissory note, should be applied first to accrued interest, secondly to accrued rental, and then to the open account.

The following resolution is also contained in these minutes:

> RESOLVED: That the officers of the corporation be directed to execute a promissory note in the amount of $200,000.00, payable to Mr. O. H. Kruse, payable on December 31, 1950, and to bear interest at the rate of 6% per annum if unpaid on January 1, 1951.

O. H. Kruse conveyed the following assets to the appellant corporation and accepted in payment therefor its promissory note in the principal sum of $200,000.00 and an open account in his favor in the amount of $18,579.29: (Stipulation, See Tr. p. 25).

Accounts Receivable	$139,506.62
Merchandise Inventory	37,724.59
Cash	41,348.08
	$218,579.29

In addition to the tangible assets transferred by O. H. Kruse to the appellant corporation in exchange for 800 shares of its capital stock; its promissory note in the amount of $200,000.00, and an open book account in his favor of $18,579.29, the said O. H. Kruse transferred intangible assets, including good will, and contracts with various feeding associations in the Bellflower, San Dimas, Chino Valley and Baldwin Park areas, whose members buy from one source. (Tr. pp. 57 & 58). The cooperative guarantees the accounts

receivable representing purchases by its members, who buy on terms that are substantially equivalent to cash, (ten to fifteen day accounts). They will guarantee a mark-up over the current grain quotations to the producers of the feed. (Tr. pp. 61 & 62). Mr. Kruse received nothing from the corporation for these intangible assets. (Tr. pp. 59 & 63).

Appellant kept its books and reported its income and expenses in its federal income and excess profits tax returns on the accrual basis of accounting. (Joint Exhibits G, 17A, 18B).

The corporate journal entry for each month of 1952 and 1953 shows a debit to "Interest" or "Interest Expense" and a credit to "Accrued Interest." These monthly journal entries were posted to ledger sheets entitled "Accrued Interest." (See Exhibits 7 through 14, inclusive).

Appellant had a line of credit of $100,000.00 with the Bank of America established on November 3, 1951, and on said date O. H. Kruse and Helen D. Kruse signed a subordination agreement subordinating the $200,000.00 note obligation to any existing loan with the bank. (Exh. I, Tr. pp. 138, 139 & 140).

In 1950, appellant corporation deducted accrued interest of $9,000.00 and accrued rent of $9,000.00, both

payable to O. H. Kruse. (Exh. G).

In 1951, appellant corporation deducted $12,000.00 interest payable to O. H. Kruse, and O. H. Kruse (Tr. p. 143), who reported his income on the cash method of accounting at all times, reported no interest received from appellant corporation but incorrectly reported $21,000.00 as rental income. Nothing was actually paid on interest during 1951 by appellant corporation to O. H. Kruse. (Exh. H).

In 1952, appellant corporation deducted accrued interest of $12,000.00 owing to O. H. Kruse. (Joint Exh. 17A). In this year O. H. Kruse reported only $6,000.00 interest received from appellant corporation. Nothing was actually paid on interest during 1952. (Joint Exh. 19C).

In 1953, appellant corporation deducted accrued interest of $12,000.00 owing to O. H. Kruse. (Joint Exh. 18B). O. H. Kruse reported $12,000.00 interest received from appellant in 1953. (Joint Exh. 20D).

Appellant paid $2,000.00 interest in September, 1953, to O. H. Kruse. (Exh. 14). Payment of appellant corporation's note to O. H. Kruse was made in installments as follows: (Stipulation, See Tr. p. 26).

November 1, 1955	$100,000.00
April 12, 1957	20,000.00
October 22, 1958	80,000.00

All other pertinent facts relating to the predecessor business of Otto H. Kruse, and the sale of that business to the appellant are contained in the Stipulation of Facts; Transcript of Record, pages 56, 57, 58, 61, 62, 71, 72, 75 and 76; and appellant's Exhibits 5 and 6.

The promissory note involved herein was received in evidence by the Court as appellant's Exhibit 1. (See appendix p. B).

All other pertinent facts relating to the issuance of the said note are contained in the Transcript of Record, pp. 105 and 106, and appellant's Exhibits 5 and 21, and appellee's Exhibit I.

The facts relative to the accrual of interest on the said promissory note on the books of appellant corporation are contained in appellant's Exhibits 7, 10 and 14.

The amounts reported by O. H. Kruse in his individual income tax returns for the years 1951, 1952 and 1953 are shown in joint Exhibits 19C and 20D.

Fray L. Hobson, accountant, admits errors in preparing personal federal income tax returns for O. H. Kruse for the years 1951 and 1952. (Tr. p. 138).

The said Fray L. Hobson was elected assistant secretary of the appellant corporation at a regular

meeting of its board of directors held on June 15, 1950. (Appellant's Exh. 5).

ISSUE TO BE DECIDED

Whether the promissory note in the amount of $200,000.00 issued by appellant corporation to O. H. Kruse in payment for certain specified assets having an equal value was intended to be a bona fide indebtedness of appellant corporation or a contribution to capital.

POINTS RELIED UPON BY APPELLANT

Appellant relies upon the following points on appeal:

(1) That the promissory note in the amount of $200,000.00 issued by appellant corporation to O. H. Kruse in payment for certain specified assets having an equal value was intended to be, and was, in fact, evidence of a bona fide indebtedness of appellant corporation, and not a contribution to capital.

(a) In general.

(b) That the note had a fixed maturity date and was not a demand note, and, therefore, does not permit an inference that a bona

fide indebtedness was not intended.

(c) That the fact that the Bank of America required appellant corporation to execute a printed form of subordination agreement does not leave a permissable inference that the payee of the note, O. H. Kruse, did not intend to enforce payment by appellant corporation.

(d) That the fact that appellant corporation's accountant made mistakes in connection with appellant's income tax returns should not be significant in determining whether there was actually a bona fide indebtedness of appellant corporation to O. H. Kruse.

(e) That the fact that the note was unsecured is not significant in determining whether there was, in fact, a bona fide indebtedness.

(f) That the fact that O. H. Kruse failed to testify at the trial is not a significant fact in determining whether or nor there was a bona fide indebtedness of appellant corporation.

ARGUMENT

I

THE PROMISSORY NOTE IN THE AMOUNT OF $200,000.00 ISSUED BY APPELLANT CORPORATION TO O. H. KRUSE IN PAYMENT FOR CERTAIN SPECIFIED ASSETS HAVING AN EQUAL VALUE WAS INTENDED TO BE, AND WAS, IN FACT, EVIDENCE OF A BONA FIDE INDEBTEDNESS OF APPELLANT CORPORATION.

(a) IN GENERAL

The promissory note dated June 15, 1950, involved in this proceeding, in the principal sum of $200,000.00, and bearing interest at the rate of 6% per annum, was drawn on a form usually used only for that purpose. (Exh. 1; see appendix p. B). Words common to an evidence of an indebtedness are used throughout. It was properly recorded on the books of appellant corporation as an obligation, and correctly reflected on the financial statements furnished by appellant to the banks and others. (Exhibits F, G, 17A, 17B and I).

In the case of John Wannamaker of Philadelphia, 1 TC 944, the Court said:

> "It is the generally accepted rule that the name given to the instrument is not conclusive and that inquiry may be made as to its real character, but it is not lightly to be assumed that the parties have given an erroneous name to the transaction."
>
> (Underscoring ours).

A condensed expression of the same view is stated in the case of Clyde Bacon, Inc., 4 TC. 1107, citing Commissioner v Proctor Shop, Inc., 82 Fed. (2d) 792; Jewel Tea Co. v United States, 90 Fed. (2d) 451; Kentucky River Coal Corporation, B. T. A. 644.

Many different tests have been applied by the courts in reaching an opinion as to the recognition of a note as evidence of indebtedness, as opposed to risk capital. Those which have been most frequently applied are:

(a) Was there a good business purpose for the issuance of the note?

In the instant case the note was issued for assets having a value equal to the principal amount of the note. (Stipulation).

(b) Is the obligation to pay positive and unconditional, or subject to a contingency?

The promissory note issued to O. H. Kruse by the appellant corporation for certain of his assets constituted evidence of an indebtedness founded upon a positive obligation to pay. O. H. Kruse was entitled, independently of the risk of success of the business, to the return of the money loaned, and the full amount of the note has been paid to him.

Of interest on this subject is the case of Wilshire & Western Sandwiches, Inc., v Comm., 175 F (2d) 718, C.A.

9th. The board of directors of the plaintiff decided that of the $55,000.00 actually advanced by the incorporators, $25,000.00 would be taken as loans, and $30,000.00 would be taken as capital contributions for which stock was issued. Promissory notes, maturing in two years with interest at 6% payable quarterly, were issued for the loans. No interest was in fact paid until December, 1943, apparently after the notes became due, when it was paid through November, 1943. The principal was paid in installments on April 21, 1943, May 23, 1944, and March 23, 1945, at which time the remaining interest was also paid. The amount of the loans was not set up on the corporation's books as indebtedness because the accountant was not informed that part of the advances made by the incorporators was made as loans.

One of the incorporators testified that he expected to be repaid if the corporation had funds for that purpose, and another testified that he expected to be paid out of current earnings and would not have insisted upon payment if it would cause financial hardship to peritioner. The interest and principal was paid from earnings.

The Court, in its opinion, stated:

> "It is not contended that a corporation is without power to enter into a debtor and creditor relationship with its stockholders."

It held that the advances were loans and that the interest paid thereon was deductible under Section 23(b) Internal Revenue Code, 1939.

(c) Does the note bear interest?

The promissory note issued by the appellant corporation with which we are concerned bore interest at the rate of 6% per annum from January 1, 1951. It was only non-interest bearing for the first 6 1/2 months, that is, from June 15, 1950, to December 30, 1950. (Exh. 1; see appendix p. B).

In Ruspyn Corporation, 18 TC 769, debenture bonds at issue were held by the Tax Court to be a valid indebtedness of the corporation. The Tax Court found that under the terms of the debenture bonds, they mature on May 1, 2019, or in something more than 89 years after their issuance, and 4 years after the expiration of the lease covering petitioner's principal asset. Also, that for the first 6 years interest was payable only if earned, and any unearned interest did not accumulate. The Court's opinion contains no information as to whether the officers of the corporation gave any testimony regarding the unusual terms of the debentures, which would serve to explain them.

In Commissioner v Page Oil Co., 129 F 2d 748, (C.A.2), affirming 41 B. T. A. 952, the payees of the notes in question agreed that the notes would bear no interest

until the year 1934 which was 4 years after their issuance. This was not held fatal to a valid indebtedness.

(d) Does the note carry voting rights?

The note at issue carried no voting rights under any conditions.

(e) Was there a substantial investment in capital stock?

It has been stipulated as a fact that the appellant corporation received valuable consideration for the issuance of its promissory note to O. H. Kruse. The record discloses that the appellant corporation issued $80,000.00 par value of its capital stock for assets having an equal value (Stipulation, see Tr. pp. 24 and 25; and Tr. p. 57), and that O. H. Kruse contributed intangible assets having a reasonable value of $200,000.00 to the appellant corporation for no consideration. (Tr. pp. 58, 59 and 63).

The Tax Court, in its written opinion, applies some different tests in reaching its opinion that the note in question is not a bona fide evidence of indebtedness. The Tax Court's opinion will be answered hereinafter under (b), (c), (d), (e) and (f) of this brief.

Of particular interest to the general question at bar is the case of Chas. Schaefer & Son, Inc., 9 T.C.M. 17964. The petitioner therein was engaged in business as

a wholesaler, dealing in hay, grain, flour, and salt, and took over a business originally conducted as a proprietorship. The corporation had capital stock issued in the amount of $86,437.14, and issued notes in the aggregate principal sum of $300,000.00, bearing interest at the rate of 7% per annum. The said notes did not have to be paid for 50 years, but they could be paid sooner. Interest was to be paid as and when declared by the board of directors. It was provided that, "The Board of Directors shall declare interest payable when and as the net income of the corporation will permit."

The Court, in deciding this issue in favor of the taxpayer, observed that the time of maturity, while distant, was not unreasonable under the circumstances; also, that the payment of interest currently was made to depend upon earnings, but the obligations evidencing the indebtedness could nevertheless be notes.

In the instant proceeding the note involved became payable on demand after December 31, 1950, (Exh. 1). One-half of the principal amount of the note was paid in 1955, and the remainder was liquidated by payments made in 1957 and 1958. (Stipulation, See Tr. p. 26). Interest was payable on such notes regardless of whether or not there were corporate earnings out of which it could be paid, and no action by the Board of Directors was required

before payment could be made.

It is submitted that all of the general tests used in deciding an issue such as the one at bar are resolved favorably towards appellant, and the tests set forth in the opinion of the Tax Court, and the inference made therefrom (hereinafter discussed) are without merit.

(b) THE NOTE HAD A FIXED MATURITY DATE AND WAS NOT A DEMAND NOTE, AND, THEREFORE, DOES NOT PERMIT AN INFERENCE THAT A BONA FIDE INDEBTEDNESS WAS NOT INTENDED.

After stating that one of the factors to consider in determining whether a bona fide indebtedness was intended is the presence or absence of a fixed maturity date for the instrument, the Tax Court, in its opinion, states that the note at bar was a demand note. (Opinion, See Tr. p. 35). It is submitted that the note had a definite maturity date and that is December 31, 1950. The note provided for payment "on or before December 31, 1950."

Even if the note may be considered as a demand note, it is still valid evidence of a bona fide indebtedness. See, Commissioner v. Page Oil Co., Supra.

The Tax Court appears to accept such law when it states that "We need not say that in all cases a demand note given to a stockholder would not evidence an indebtedness." (Opinion, See Tr. pp. 35 and 36). However, it supports its conclusion by citing Gooding Amusement Co.,

23 T. C. 408 and the affirming opinion in Gooding Amusement Co. v. Commissioner, 236 F 2d 159. (Opinion, See Tr. p. 25). That portion of the Gooding Amusement Co. case cited by the Tax Court does not deal with the subject of whether the note is a demand note or one with a fixed maturity. It deals with impairing the financial standing of the corporation. The Tax Court opinion follows by a statement that the Gooding Amusement Co. case points up the failure of Mr. Kruse to testify (this argument will be discussed infra), and the "unexplained terms of the note." It is submitted that the clear and concise language of the note leaves no "unexplained terms."

It appears to appellant that Gooding Amusement Co., supra, is clearly distinguishable on the facts. For one thing, depreciable assets carried on the partnership books in the Gooding case which had a value of $129,899.13 were transferred to the corporation at a value of $247,832.23. Secondly, no cash was transferred to the corporation, but assets valued at only $184,444.23 were transferred to the corporation for only $49,000.00 of its capital stock and promissory notes which totaled $232,001.10. It can immediately be seen that the figures are disproportionate which is something we do not have in the case at bar. In the instant case the note was

received for assets having an equal value. Another distinguishing factor is that the portion of the assets contributed for the shares of stock in the Gooding case and that contributed for the notes was not identified. In addition, the court in the Gooding case based its reasoning in part upon the fact that the petitioner's wife and infant daughter were amenable to petitioners' desires with respect to the notes. Since petitioner's wife and infant daughter didn't need the funds it was immaterial to them whether the notes were paid or not.

The Courts have recognized that the consecutive steps involved in the incorporation of a business, occurring in immediate sequence, may nevertheless be entirely different in nature and therefore separate and distinct legal transactions, although closely related in time and purpose. Sun Properties, Inc. vs. U. S., 220 Fed. (2d) 171; Marjorie Taylor Hardwick, 33 B.T.A. 249; W. A. Hoult, 23 B.T.A. 9-4.

See also Warren H. Brown, et al., 27 TC 27

(c) THE FACT THAT THE BANK OF AMERICA REQUIRED APPELLANT CORPORATION TO EXECUTE A PRINTED FORM OF SUBORDINATION AGREEMENT DOES NOT LEAVE A PERMISSABLE INFERENCE THAT THE PAYEE OF THE NOTE, O. H. KRUSE, DID NOT INTEND TO ENFORCE PAYMENT BY APPELLANT CORPORATION.

The Tax Court in its opinion (See Tr. p. 36) states

that the "unexplained terms of the note instrument leaves a permissable inference that O. H. Kruse, at the time he had his corporation issue the note to him, did not intend to enforce payment by his corporation if by so doing his corporation would be at all inconvenienced." The Tax Court proceeds to state that "This inference is somewhat strengthened by the subordination agreement executed by O. H. Kruse and his wife in November, 1951 with the Bank of America at the time the corporation established a $100,000.00 line of credit with the bank." (Opinion, See Tr. p. 36).

While making this inference, the Tax Court has not suggested that it was unusual practice for a bank to require such an agreement in the case of an unsecured loan. The Tax Court has also not seen fit to attempt to distinguish the facts relating to such subordination agreement (Exh. I), in the instant case, from those found by the Courts in the many cases where such an agreement was found to exist, some of which are listed below.

John Kelley Company v. Commissioner, 326 U.S. 521; 66 S.Ct. 299 affirming 1 T.C. 457 (Payment of debentures was conditioned on the sufficiency of net income to meet the obligation, and the debenture holders were subordinated to all other creditors).

Clyde Bacon, Inc., supra.

Proctor Shop, Inc., 30 B.T.A. 721; affirmed C. A. 9th; 82 Fed (2d) 795

John W. Walter, Inc., 23 T.C. 550

In the Walter case, supra, Dun and Bradstreet refused to give the corporation a credit rating until John W. Walter and the corporation signed a subordination agreement whereby the corporate debentures were subordinated to the claims of Dun and Bradstreet, and general creditors. The debentures could not be sold or retired without giving creditors ninety days notice. The Tax Court in its opinion said:

> "Our finding that the Petitioner received valuable consideration for the issuance of its debentures disposes of the issue in Petitioner's favor."

Commissioner v. Page Oil Co., 129 Fed (2d) 748; (C.A. -2) affirming 41 B.T.A. 952. In this case the Court found that Page Oil Co., in 1930, acquired certain oil and gas properties in exchange for all of its capital stock (1,600 shares); its note for $161,650.00 due on demand with interest, and four subordinate notes each in the amount of $500,000.00, payable on demand, on or after five years from date with interest at 6% per annum. Each note contained the provision:

> "This note is given in payment of a part of the purchase price of oil and gas premises and is subordinate in payment to a series of notes

aggregating Three Hundred Four Thousand Two Hundred Seventy Six Dollars Forty Cents and is likewise subordinate in payment to any notes which may be made by this company for the purpose of paying the cost of developing any oil or gas property owned by it."

The payee of the notes also agreed that the notes would bear no interest until 1934 (four years after issuance), and that they would be subordinated to payments on a mortgage on the property purchased and to the payment of the operating expenses of the corporation.

In its opinion, the Court said:

> "In Commissioner v. O. P. Holding Corp., 76 Fed. (2d) 11, we had occasion to deal with a similar situation involving subordinated debenture bonds instead of notes. We then said: 'We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors.'"

Another inference indulged in by the Tax Court, which is closely aligned with the subordination agreement, is the statement in its opinion (see Tr. p. 38) that although the appellant corporation paid its obligations other than the note at issue promptly, it made no payment on the principal on this note until November, 1955. The answer to this is found in the opinion of the Court in Bakhaus & Burke, Inc., 14 TCM 919, which reads in part, as follows:

"Lastly respondent relies upon the failure of the stockholder creditors to demand payment of the debt. The following language from Earle v. W. J. Jones & Son, 200 Fed (2d) 846, 850 is particularly dispositive of this contention:

'***Certainly failure to attempt to collect a debt does not per se destroy its character as such; and the same strict insistence upon payment on the due date as would be the case if a bank were the creditor should not be expected where a shareholder, or one who is closely identified therewith, is a creditor.***'

(d) THE FACT THAT APPELLANT CORPORATION'S ACCOUNTANT MADE MISTAKES IN CONNECTION WITH APPELLANT'S INCOME TAX RETURNS SHOULD NOT BE SIGNIFICANT IN DETERMINING WHETHER THERE WAS ACTUALLY A BONA FIDE INDEBTEDNESS OF APPELLANT CORPORATION TO O. H. KRUSE.

Particular emphasis, we believe, is placed by the Tax Court upon certain mistakes made by appellant's accountant. (Opinion, See Tr. pp. 36, 37, 38, 39 and 40).

Through error, interest was accrued on the appellant's books for the nine months period of the corporate existence in 1950, although, by the terms of the note, no interest was due for that period. This error had been corrected, and the additional tax due as a result of the correction paid, prior to the commencement of

the revenue agent's examination of the appellant's books and records for the years 1952 and 1953.

There are errors in the Federal income tax returns of O. H. Kruse and his wife for the year 1951 (Exh. H), which year is not involved in this proceeding, and 1952 (Exh. 19C), which is one of the years involved herein. They are incomprehensible errors which bear no relation to the deductibility of the interest on the appellant's note. This is particularly true in view of the Court's finding that the doctrine of constructive receipt was applicable with respect to the rental accruals.

The error in 1951 resulted from the accountant's action in reporting the sum of $21,000.00 as income from rent in the personal return of O. H. Kruse and his wife, although the only amount of rent due and payable at the close of 1951 was $12,000.00 (Exh. 5), and in complete disregard of the order of the appellant's board of directors that payments made to O. H. Kruse should be first applied to accrued interest on the note. (Exh. 5).

Clearly, $12,000.00 of the amount reported ($21,000.00) represented interest, and only the balance was applicable to the accrued rent.

In 1952, the accountant who prepared the personal

return of O. H. Kruse and his wife reported therein the amount of $12,000.00 as rental income and $6,000.00 as interest income (Exh. 19C), in disregard of the specific instructions of the appellant's board of directors. (Exh.5).

It has long been established that income is to be determined from actual facts, as to which books of account are only evidential.

Doyle v. Mitchell Bros., 247 U.S. 179
Southern Pacific Co. v Muenter (C.A. --9)
Cert. denied U.S. 611
Duffin v Lucas, 55 Fed (2d) 786
Clarence E. Baldwin v. Comm. 14 T.C.M. 694

The following statement of the Court in Commissioner v. Columbia River Paper Mills, (C.A. --9) 126 F (2d) 1009, is deemed to be equally applicable to the facts in the instant case:

> "There is no occasion for placing a strained construction upon the statute, or for subjecting the simple agreement to an accountant's interpretation. As said in Old Colony Railroad Co. v. Comm., 284 U.S. 552, 561; 52 S. Ct. 211, 214, 76 L. Ed. 48, we think that, in common understanding interest means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and

theoretic analysis."

Appellant urges the Court to look to the substance and form of the note and the facts surrounding the execution of the note, rather than to decide against appellant by inferences drawn from incomprehensible errors which could not possibly have been made by the accountant for any specific purpose. In other words, it is submitted that the only inference that can be drawn from the facts is that there were mistakes and that to then infer from the mistakes that a bona fide indebtedness was not intended, is piling inference upon inference similar to double hearsay where one person testifies that Mr. X told him that Mr. Y told him that such and such occurred.

(e) THE FACT THAT THE NOTE WAS UNSECURED IS NOT SIGNIFICANT IN DETERMINING WHETHER THERE WAS, IN FACT, A BONA FIDE INDEBTEDNESS.

An unsecured note was held in each of the following cases to be a bona fide indebtedness of the corporation rather than a contribution to capital. See, John Kelley Co. v. Comm., 326 U.S. 521; Comm. v. Page Oil Co., supra; Comm. V. Proctor Shop, Inc., supra; Chas. Schaefer & Son, Inc., supra; Sun Properties, Inc. v. U. S., supra; Bakhaus & Burke, Inc., supra.

It is submitted by appellant that citation of authority to the effect that an unsecured debt is just as much a debt as one that is secured is wholly unnecessary.

(f) THE FACT THAT O. H. KRUSE FAILED TO TESTIFY AT THE TRIAL IS NOT A SIGNIFICANT FACT IN DETERMINING WHETHER OR NOT THERE WAS A BONA FIDE INDEBTEDNESS OF APPELLANT CORPORATION.

The trial court noted that the "significant fact" in this case is that petitioner sought to establish its burden without the testimony of O. H. Kruse. (Opinion, See Tr. 33). The Court stresses the failure of O. H. Kruse to testify "for the unexplained terms of the note instrument leaves a permissable inference that O. H. Kruse, at the time he had the corporation issue the note in question to him, did not intend to enforce payment by his corporation if by so doing, the corporation would be at all inconvenienced." (Opinion, See Tr. 8-26). There is no basis for drawing such an inference. It is respectfully submitted that the Tax Court should not be encouraged to indulge in metaphysical gymnastics in an effort to sustain the Government's position.

In the case of Bakhaus and Burke, Inc., 14 TCM, Decision 21, 185 [M], the Tax Court said:

> "The question whether the sum transferred gave rise to an indebtedness or to a proprietory

interest depends upon the objective intent disclosed by all the pertinent factors in the case and not the formal manifestations of intent declared by the taxpayer. Isidor Dobkin, 15 T.C. 31, aff'd 192 Fed (2d) 392,; Cf. Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 Fed. (2d) 718."

Considered in the light of that pronouncement, it is difficult to imagine what purpose the personal testimony of O. H. Kruse would have served, since the terms of the note are clearly stated therein; the books of account of appellant reflect the existence of the obligation, and the proper accrual of interest thereon for the years 1951, 1952, 1953, and thereafter.

Although the trial court refers to the "unexplained terms" of the note, the note is clear and concise. It is not clear to appellant as to what Mr. O. H. Kruse could have testified to other than what is presently evidenced by the fact that appellant was organized to take over his business and that he offered to transfer certain of his assets to the corporation in exchange for its capital stock and most of his remaining assets for a promissory note, all of which is set forth in the minutes of the meetings of appellant, the note and the signed proposal, and all of which have been received in evidence and heretofore referred to.

The Tax Court seeks to imply that for reasons of

his own O. H. Kruse did not choose to testify in court as to his intent, and, that this may be considered as evidence under the well established rule that when a party fails to introduce evidence within his possession and which, if true, would be favorable to him, the presumption is that such evidence, if produced, would be unfavorable and this is especially true where the party failing to produce the evidence has the burden of proof. It must be kept in mind that in the instant case, we are concerned with written agreements entered into by and between O. H. Kruse and appellant. (Exhibits 1, 3, 4 and 5). Those agreements have been introduced in evidence by appellant, together with the promissory note. Uncontradicted testimony was given at the trial that O. H. Kruse was represented by his legal advisor, Judge Wolford. (Tr. pp. 75-78 inclusive).

In the case of Sherman v. Commissioner, (C.C.A. 9th) 76 Fed (2d) 810, it was held that the intention of parties to an agreement must be determined from its terms and testimony of the parties that they intended to cover subjects not included therein must be disregarded. See also the case of Pugh v. Commissioner of Internal Revenue, 49 Fed (2d) 76, (C.C.A. 5th) certiorari denied, 284 U.S. 642, and Jurs v Commissioner 147 Fed (2d) 805 (C.C.A. 9th) affirming TC Memo Opinion

C. C. H. Dec. 13446 [M].

No case could be found by appellant which involved the question of whether a note should be recognized as evidence of indebtedness where the court relied upon the testimony of a principal involved in making a finding as to the bona fides of the note.

In Isidor Dobkin, 15 T.C. 31 --- affirmed 192 Fed (2d) 392, it was stated as follows:

> "The determinative intent described in Wilshire & Western Sandwiches, Inc., 175 Fed (2d) 718, must necessarily be the objective intent disclosed by all the pertinent factors in the case and not the formal manifestation of intent declared by the taxpayer. Cf O'Neill v. Commissioner, 170 Fed (2d) 596 (48-2 USTC 9406) certorari denied 336 U. S. 937."

SUMMARY

The only question to be answered in this case is whether the promissory note in the sum of $200,000.00 issued by the appellant corporation to O. H. Kruse in exchange for assets having a value equal to that amount was a bona fide obligation of the appellant evidencing a true debtor-creditor relationship, within the meaning of Section 23(b), Internal Revenue Code (1939).

The note was drawn on the form usually used only for such purpose, and using only words commonly serving

to denote an evidence of indebtedness. It became due and payable on December 31, 1950, and, if not paid on that date it became payable on demand. The note bore interest at the rate of 6% per annum, if not paid on or before December 31, 1950.

It was properly recorded on the books of the appellant and reflected in its financial statements given to the banks and others.

Interest on the note was properly accrued on the books of the appellant for each of the years 1951, 1952 and 1953, and subsequent years, which books have, at all times, been kept on the accrual basis.

The Board of Directors of appellant corporation, at a meeting held on June 15, 1950, adopted a resolution providing that payment made to O. H. Kruse should be applied first to the payment of interest on the appellant's note held by him and next to the payment of rent due.

The Tax Court in the instant case held that the rental payments accrued on the books of the appellant in favor of O. H. Kruse were constructively received by him in the year in which the rental expense was accrued on the appellant's books. The reasoning of the Court would apply with equal force to the interest accrued on the appellant's books in favor of O. H. Kruse.

The personal income tax returns of O. H. Kruse for the years 1951, 1952, and 1953 were prepared by a certified public accountant who has admitted making errors in the designation of the amounts reported as income received from the appellant in 1951 and 1952. In the year 1953 the nature of the income reported was correctly stated.

This is not a case where the misnaming of the nature of the income reported by O. H. Kruse as constructively received from the appellant had some effect on his Federal income tax liability, since the entire amount was taxable to him whether described as interest or rental income.

It is urged that the errors of an accountant in failing to correctly designate the nature of the amounts reported by O. H. Kruse in his personal return, which were constructively received from the appellant, in accordance with the resolution of the board of directors of the appellant, adopted at the meeting held June 15, 1950, should have no bearing on the question at issue.

C O N C L U S I O N

For the foregoing reasons, the judgment of the Tax Court of the United States should be reversed.

Respectfully submitted,

ENGER & YARDUM

BY: LeVONE A. YARDUM

Attorneys for Appellant.

APPENDIX

"In computing net income there shall be allowed as deductions:"

"Section 23 (b) Interest -- All interest paid or accrued within the taxable year on indebtedness incurred within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

Internal Revenue Code of 1939, Section 23 (b)

$ 200,000.00 June 15, 19 50

On or before December 31, 1950 or thereafter on demand after date, for value received,

O. H. Kruse Grain & Milling, a corporation

promises to pay to Otto H Kruse

or order at El Monte, California

the sum of Two Hundred Thousand Dollars Dollars

with interest at the rate of six per cent per annum from January 1, 1951 until paid, interest payable semi-annually, and if not so paid to be compou[illegible], and bear the same rate of intere[illegible] e principal; and should the interest not be paid then the whole sum of principal and interest shall become immediately due and payable at the option of the holder of this note. Principal and interest payable in lawful money of the United States.

This note is executed in compliance with a resolution of the Board of Directors of said Corporation, duly adopted at a regular meeting of said Board and transcribed in full in the minutes of said meeting.

O. H. Kruse Grain & Milling

[SEAL]

By O. H. Kruse
President

Attest: Fray S. E. Hoban
Asst. - Secretary

NOTE — CORPORATION — WOLCOTTS FORM 1440

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